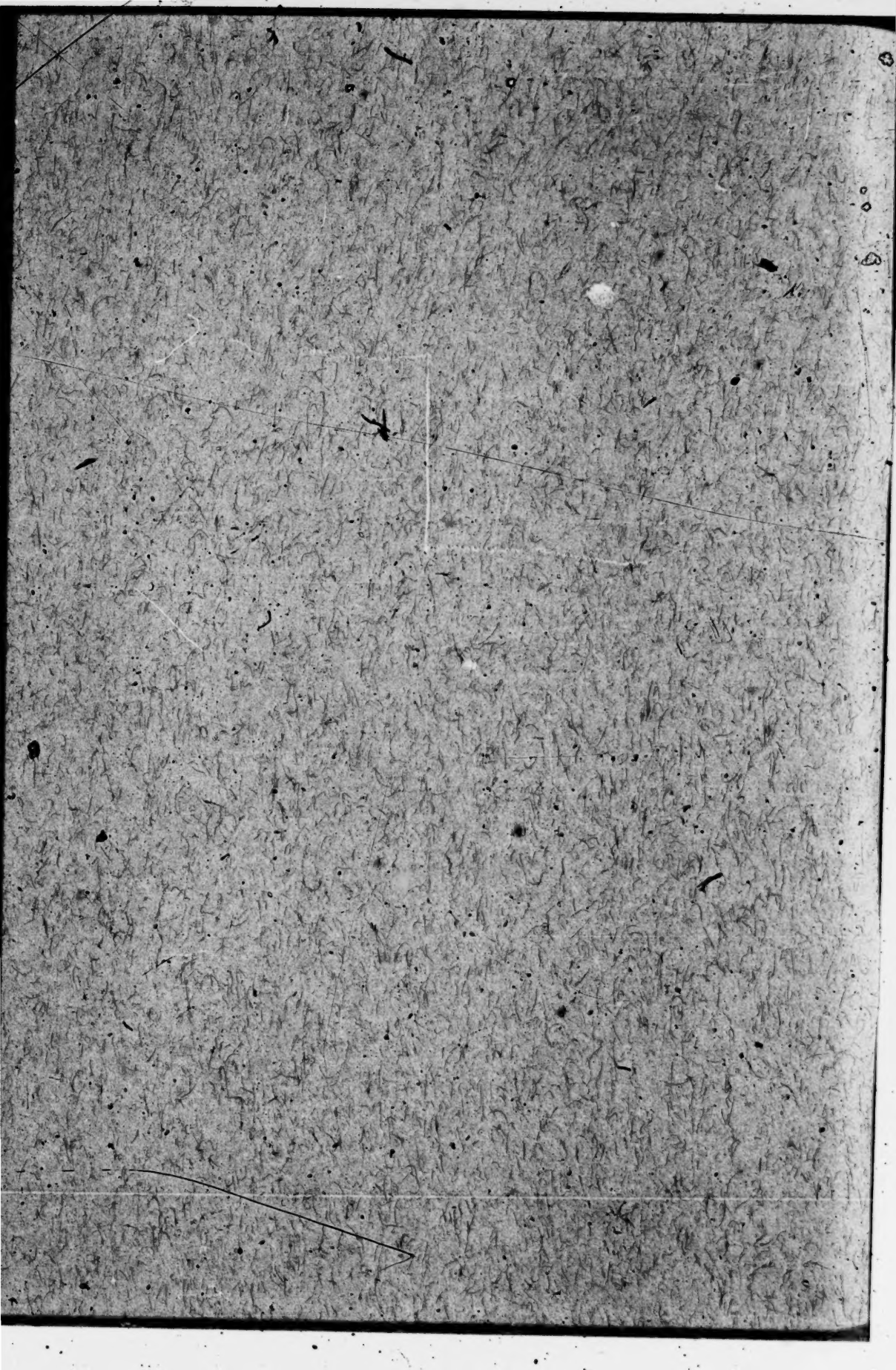


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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 467

IRVING GORDON AND MARGARET GORDON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the tax court (Pet. App. 7A–35A) is reported at 51 T.C. 1032. The opinion of the court of appeals (Pet. App. 37A–54A) is reported at 424 F. 2d 378.

JURISDICTION

The judgment of the court of appeals was entered on March 16, 1970 (Pet. App. 73A). A petition for rehearing, including a suggestion for rehearing *en banc*, was denied on May 4, 1970 (Pet. App. 74A, 75A). The petition for a writ of certiorari was filed on July 29, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the courts below correctly held that the transaction wherein petitioners, shareholders of Pacific, through the issuance of rights, purchased stock in Northwest from Pacific at a less than fair market value, did not qualify for nonrecognition of gain treatment under Section 354(a) of the Internal Revenue Code.

2. Whether the courts below correctly held that the transaction wherein petitioners acquired the Northwest stock did not qualify as a distribution in "partial liquidation" of Pacific as defined in Section 346(b) of the Code, and that petitioners consequently are not entitled to capital gain treatment.

STATUTES AND REGULATIONS INVOLVED

Pertinent statutory provisions are set forth in the Appendix to the petition (Pet. App. 1A–6A). Additional statutory provisions and pertinent Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 12–14.

STATEMENT

Petitioners were stockholders of Pacific Telephone and Telegraph Company ("Pacific"). Pacific transferred assets used in the conduct of its business in three northwestern states to a new corporation, Pacific Northwest Bell Telephone Company ("Northwest"), in exchange for the latter's stock and a $200,000,000 demand note (Pet. App. 9A). In 1961, Pacific distributed to its shareholders transferable rights, exercisable within three weeks of the date of issue, to

purchase 57 percent of its Northwest stock. One right was issued for each share of Pacific stock held, and six rights, plus the payment of $16, were necessary to purchase one share of Northwest stock (Pet. App. 10A). Approximately two years later, Pacific distributed to its shareholders similar transferable rights to acquire the remaining 43 percent of its Northwest stock, the only variation being that eight rights, plus $16, were necessary to purchase one share of Northwest stock (Pet. App. 10A–11A).

In 1961, petitioners exercised 1536 of the 1540 rights issued to them and acquired 256 shares of Northwest stock, paying $4,096 therefor. They reported no income from this transaction. The commissioner treated the difference between the fair market value of the Northwest stock purchased ($6,896.64) and the cash paid for the stock as a dividend and asserted a deficiency accordingly. (Pet. App. 12A.)

This case was previously before this Court in *Commissioner* v. *Gordon*, 391 U.S. 83 (Pet. App. 55A–71A). It was initially tried in the Tax Court, together with the companion case of *Baan* v. *Commissioner*, 45 T.C. 71. The Baans were also shareholders of Pacific who exercised their rights to buy Northwest stock (Pet. App. 12). In the earlier proceeding in the Tax Court, petitioners and the Baans argued that dividend treatment was precluded either by Section 354(a) (Pet. App. 2A–3A) (nonrecognition of gain or loss on exchanges of stock and securities pursuant to certain reorganizations) or by Section 355 (Appendix, *infra*, pp. 12–13) (nonrecognition of gain or loss on distribution of stock and securities of a controlled corporation).

They argued alternatively that if there were any taxable income, such income would be taxable as capital gain under Section 346(b) (Pet. App. 1A–2A) (definition of partial liquidations). The Tax Court agreed with the Section 355 argument and did not pass on the other arguments advanced by petitioners and the Baans (Pet. App. 13A). On appeal by the Commissioner, the Second Circuit affirmed, *Commissioner* v. *Gordon*, 382 F. 2d 499, and the Ninth Circuit reversed, *Commissioner* v. *Baan*, 382 F. 2d 485. This Court granted certiorari to resolve the conflict, 389 U.S. 1033, 1034.

The Court held, 391 U.S. 83, 93–96 (Pet. App. 67A–69A) that Section 355 did not apply because, although required by Section 355(a)(1)(D), Pacific failed to divest itself of "control" of Northwest in 1961 when it first distributed rights to its shareholders to acquire Northwest stock. The cases were accordingly remanded for consideration of the remaining arguments under Sections 354(a) and 346(b). On remand, the Tax Court held for the Commissioner (Pet. App. 7A–35A), and petitioners and the Baans appealed. Petitioners now seek certiorari from the Second Circuit's affirmance of the Tax Court's decision (Pet. App. 37A–54A). The Baans' appeal awaits argument and decision in the Ninth Circuit.

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other reason for further review by this Court.

1. Section 354(a) (Pet. App. 2A–3A) provides for nonrecognition of gain or loss in connection with ex-

changes of stock or securities pursuant to certain corporate reorganizations. Petitioners contend that Section 354(a) applies here because: (a) their rights to purchase Northwest stock were "stock" or "securities" of Pacific (Pet. 18–21); and (b) the spinoff of Northwest by Pacific was a "reorganization" within the meaning of Section 368(a)(1)(F) (Pet. 9). If petitioners are wrong on either point, they fail to qualify for nonrecognition treatment under Section 354(a).[1]

(a) Both the Tax Court and the court of appeals held (Pet. App. 16A–17A, 41A) that the rights issued to petitioners by Pacific to acquire stock in Northwest did not constitute Pacific "stock." The Tax Court also held (Pet. App. 16A–17A) that the rights were not Pacific "securities." The court of appeals did not decide the latter point, observing (Pet. App. 41A–42A) that if the rights were "securities," they fell within the definition of "property" in Section 317(a) (Appendix, *infra*, p. 12), and, as such, would have been taxable as dividends when received, in accordance with the provisions of Section 301(a) (Appendix, *infra*, p. 12). The holdings below are confirmed by Section 1.354–1(e) of the Treasury Regulations on Income Tax (1954 Code) (Appendix, *infra*, p. 14), which specifically provides that "stock rights or war-

[1] To establish their right to nonrecognition treatment, petitioners also must show that the exercise of their rights constituted an "exchange" of stock or securities for Northwest stock. The court of appeals did not pass on this question (Pet. App. 45A), which was decided adversely to petitioners in the Tax Court (Pet. App. 17A–18A), and we do not deal with it here.

rants are not included in the term "stock or securities." Since that administrative definition is neither unreasonable nor inconsistent with the statute, it should be sustained. *Bingler v. Johnson*, 394 U.S. 741, 749–751; *Commissioner v. South Texas Co.*, 333 U.S. 496, 501.[2]

Any definition of stock would include three privileges inherent in stock ownership: (1) the right to vote at shareholder meetings; (2) the right to participate in dividend distributions; and (3) the right to share in net assets on dissolution. See *Himmel v. Commissioner*, 338 F. 2d 815 (C.A. 2). Petitioners obtained none of these privileges when they received rights to purchase Northwest stock (Pet. App. 42A). They received only an option to acquire corporate property of Pacific within a three-week period, which they could exercise or sell to someone else. That option cannot be considered Pacific stock. As this Court stated long ago in *Helvering v. Southwest Corp.*, 315 U.S. 194, 200, "Whatever rights a warrant holder may have * * * he is not a shareholder."

It is likewise not correct to view the rights, which are short-term options, as "securities." It has long been accepted that the term "securities" refers to debt obligations of the distributing corporation that give the recipient "a continuing interest in the enterprise different from that of general creditor." *Bedford v. Commissioner*, 150 F. 2d 341, 343 (C.A. 2).

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[2] On the first appeal in *Commissioner v. Baan*, *supra*, the Ninth Circuit stated in considering the Section 355 question (382 F. 2d at p. 492) that "Stock rights are not stocks or securities * * *."

Accord, *Shenandoah Rayon Corp.* v. *Commissioner*, 122 F. 2d 268, 270 (C.A. 2), certiorari denied, 314 U.S. 696; *Neville Coke & Chemical Co.* v. *Commissioner*, 148 F. 2d 599, 602 (C.A. 3), certiorari denied, 326 U.S. 726.

Petitioners do not assert a direct conflict of decisions on the question whether the rights involved constituted "stock or securities." They allege (Pet. 20) a conflict "in substance" with *Carlberg* v. *United States*, 281 F. 2d 507 (C.A. 8), and *Hamrick* v. *Commissioner*, 43 T.C. 21. Those cases are distinguishable for a variety of reasons. It is sufficient to note here that in each of them the rights were for the issuing corporation's own stock, not for the stock of another corporation, and the rights had no option feature—the stock was to be issued without the payment of additional consideration upon the occurrence of a specified contingency.

Nor is there any conflict between the court of appeals' conclusion, that if the rights were "securities" they would have been taxable as dividends upon receipt, and *Palmer* v. *Commissioner*, 302 U.S. 63, as petitioners contend (Pet. 16–18). *Palmer* was decided under the 1939 Code. In view of the unequivocal language of Sections 301(a) and 317(a) of the 1954 Code, we think that the court of appeals' conclusion is clearly correct. But apart from this, *Palmer* did not lay down an absolute rule that rights to purchase stock can never be taxed upon receipt. Petitioner's assertion (Pet. 16) regarding the "universal understanding" of *Palmer* is incorrect. This Court itself recognized in its prior opinion in this case (Pet. App. 63A, n. 4)

that *Palmer* decided that there was no dividend upon receipt only in a situation where the rights were to purchase stock at full fair market value. The Court stated (*ibid.*) that the dividend question presented in *this* case, where the rights permitted the recipient to purchase stock at a bargain price, "has not * * * been authoritatively settled."

(b) The holdings below regarding the "stock" and "securities" questions are themselves sufficient to sustain the Court of Appeals' ultimate conclusion that Section 354(a) is not applicable in this situation and to warrant denial of review by this Court of the Section 354(a) issue. The courts below need not have reached the further question whether the transaction qualified as "a mere change in identity, form, or place of organization" within the meaning of Section 368(a)(1)(F). (Pet. App. 5A). However, their consideration of this issue, even taken independently, affords no basis for further review.

The Tax Court held (Pet. App. 18A) that the transaction was not an "F" reorganization because the division of Pacific's business was too substantial a change to be considered "a mere change in identity, form, or place of organization." The court of appeals held, *sua sponte* (Pet. App. 45A–49A), that even if the transaction qualified under Section 368(a)(1)(F), since it also qualified under Section 368(a)(1)(D), the limitations of Section 354(b), which are applicable to "D" reorganizations nevertheless would have to be satisfied. Section 354(b) provides that nonrecognition treatment under Section 354(a) shall be available only in the case of an acquisitive "D" reorganization, not

in the case of a divisive "D" reorganization such as that involved here. Consequently, the court of appeals concluded that petitioners were not entitled to nonrecognition treatment under Section 354(a).

The Second Circuit's holding that the requirements of Section 354(b) would apply if the transaction here in question were an "F" as well as a "D" reorganization may not be consistent with *Estate of Stauffer* v. *Commissioner*, 403 F. 2d 611 (C.A. 9), and *Associated Machine* v. *Commissioner*, 403 F. 2d 622 (C.A. 9). In each of those cases, the Ninth Circuit held that where a statutory merger qualified under both Sections 368(a)(1)(A) and (F), the limitations applicable to "A" reorganizations did not apply to prevent the taxpayer from obtaining the benefits attendant to an "F" reorganization. But there is no direct conflict as asserted (Pet. 15)—*Stauffer* and *Associated Machine* involved acquisitive reorganizations, not a divisive reorganization. Moreover, petitioners are not entitled to nonrecognition treatment in any event because, as the Tax Court held, the transaction was not an "F" reorganization. The court of appeals thus need not have decided what the tax consequences would have been if the transaction qualified under Section 368(a)(1)(F).

2. Petitioners should not prevail on their alternative claim (Pet. 21–23) that their gain on the Northwest rights is taxable as capital gain because it was received in "partial liquidation" of Pacific under Section 346(b). The Tax Court held (Pet. App. 27A–

Section 331(a)(2) (Appendix, *infra*, p. 12) provides that distributions in partial liquidation shall be treated as in payment in exchange for stock. Section 346 defines the term partial liquidation.

32A) that a transaction does not necessarily qualify as a partial liquidation if the requirements of Section 346(b) are satisfied; that all of the requirements of Section 346(a)(2) must also be satisfied; and that they were not satisfied here because Pacific's distribution of rights to its shareholders was not in redemption of its stock. The Tax Court also held in the alternative (Pet. App. 32A–34A) that the requirements of Section 346(b) itself were not satisfied. The court of appeals rested its decision solely on the latter ground (Pet. App. 50A–54A).

Both courts below concluded that even if Section 346(b) is treated as an independent, self-sufficient definition of a partial liquidation so that a redemption is not a prerequisite to its application, the transaction did not qualify under that provision, since Pacific did not distribute to its shareholders all of the proceeds attributable to the termination of the telephone businesses transferred to Northwest. Contrary to petitioners' contention, the holdings below, that Section 346(b) requires distribution of all of the assets of the liquidated businesses or all of the proceeds of their sale, are in line with the Senate Finance Committee report (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 49), as well as with the report of the House Ways and Means Committee (H. Rep. No. 1337, 83d Cong., 2d Sess., p. A112). Nor can there be any question that Pacific failed to distribute all of the proceeds of the sale. It retained Northwest's $200,000,000 demand note and the $16 per share received from its shareholders for the Northwest stock. Moreover, it also retained an

interest in the Northwest assets represented by its 43 percent ownership of Northwest stock.

There is no conflict on the Section 346 issue. As for possible administrative importance, we note that although Section 346(b) has been part of the tax law since 1954, this case, in this aspect, is one of "first impression" (Pet. 21).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1970.

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[1] Petitioners state (Pet. 22, n. 13) that all of the Northwest stock was distributed, but fail to state that Pacific did not commit itself to distribution of all of the stock during the taxable year in issue. That was the basis for this Court's decision in *Commissioner* v. *Gordon*, *supra*, that the transaction was not tax free under Section 355.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * * * *

SEC. 317. OTHER DEFINITIONS.

(a) *Property.*—For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

* * * * * * *

SEC. 331. GAIN OR LOSS TO SHAREHOLDERS IN CORPORATE LIQUIDATIONS.

(a) *General Rule.*—

* * * * * * *

(2) *Partial Liquidations.*—Amount distributed in partial liquidation of a corporation (as defined in section 346) shall be treated as in part or full payment in exchange for the stock.

* * * * * * *

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on Distributees.*—

(1) *General Rule.*

If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax, then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

* * * * *

Treasury Regulations on Income Tax (1954 Code). (26 C.F.R.):

Sec. 1.354–1 *Exchanges of stock and securities in certain reorganizations.*

* * * * *

(e) For the purpose of section 354, stock rights or stock warrants are not included in the term "stock or securities".

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